Economic Update
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Economy Working Through 'Current Soft Spot'

FED CUTS INTEREST RATES, CITING 'GREATER UNCERTAINTY'

Recent data confirm that the U.S. economy continues to struggle to gain significant forward momentum. Forecasters generally agree that economic growth is slowing significantly in the closing months of 2002, reflecting lower consumer confidence and sluggish performance in labor markets and in the manufacturing sector. In response to the incoming data – and in an effort to provide additional support to economic activity – the Federal Reserve's Federal Open Market Committee [FOMC] on November 6 cut interest rates. It was the FOMC's first rate cut since December 2001.

The short-term economic sluggishness largely reflects the uncertain environment that businesses and investors face. Although faster short-run growth would be desirable, the fundamentals are in place for an eventual return to stronger real economic growth, with a sustained expansion in coming years.

The Blue Chip Outlook

As reflected in the *Blue Chip* survey, private forecasters generally expect the U.S. economy to grow slowly in the final quarter of 2002, with real gross domestic product [GDP] growing at about a 1.6-percent annual rate – down from the 3.1-percent rate recorded in the third quarter (see table). Nevertheless, real GDP growth is expected to pick up to a 3.3-percent rate during 2002.

Although the expectations of continued growth are encouraging, ongoing productivity gains and the slow nature of the recovery are contributing to the continued sluggish performance of labor markets; the unemployment rate is expected to remain near 5¾ percent over the next year. The outlook for continued low inflation and low interest rates – consumer price index [CPI] inflation and the 3-month Treasury bill rate are both expected to be near 2 percent next year – reflects the expected moderate pace of real economic growth.

Blue Chip Economic Outlook, November 2002

	2002.1	2002.2	2002.3	2002.4	2003 Avg.
	(percent)				
	----------- (History) -----------				
Real GDP Growth	5.0	1.3	3.1	1.6	3.3
Unemployment Rate	5.6	5.9	5.7	5.8	5.8
CPI Inflation	1.4	3.4	1.8	2.3	2.2
3-month Treasury Bill	1.7	1.7	1.7	1.5	1.9
10-year Treasury Note	5.1	5.1	4.3	4.0	4.5

Note: For 2003, rate of change is for 4th quarter 2002 to 4th quarter 2003; annual average levels for unemployment and interest rates.

The Federal Reserve Cuts Interest Rates

As noted, the FOMC, at its November 6 meeting, decided to lower its target for the Federal funds rate – the interest rate on overnight loans in the banking system – by 50 basis points (½ percentage point), to 1¼ percent, from the 1¾-percent rate set last December. In its public statement after the meeting, the FOMC acknowledged: "[I]ncoming data have tended to confirm that greater uncertainty, in part attributable to heightened geopolitical risks, is currently inhibiting spending, production and employment." The statement also said: "[A]dditional monetary easing should prove helpful as the economy works its way through this current soft spot." Such language has no technical definition in economic literature, but it does seem to convey the Fed's view. It implies a temporary and short-lived period of low growth, without suggesting an actual downturn.

Balanced Risks?

A review of recent data reinforces the perception of "softness" – largely because of the environment of heightened uncertainty and risk.

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The various data pointing to good future growth prospects include the following:

- *Historically low interest and inflation rates*. The 3-month Treasury bill rate is below 1.25 percent and the prime rate is at 4.25 percent. Inflation also continues at low rates, with CPI inflation at 1½ percent over the past 12 months, and the CPI excluding food and energy at just over 2 percent. It has been 40 years since interest rates and inflation persisted at such low levels.

- *Mild recession and relatively low unemployment.* Last year's recession was relatively mild, with real GDP declining only 0.6 percent. The unemployment rate, at 5.7 percent, is relatively low for this stage of the business cycle – and only somewhat higher than the 5.0-percent rate that the Blue Chip forecasters project is consistent in the long run with stable inflation.

- *Consumer resilience.* Personal consumption spending has held up remarkably well during the recession and early recovery, yet the personal saving rate also has been increasing. Clearly, last year's income tax cuts have played a critically important role in boosting household finances at precisely the right time. Continued high residential real estate values also are bolstering household wealth.

- *Tax incentives boosting investment rebound potential.* Large declines in investment during the recession, coupled with the high rates of depreciation of the shorter-lived capital stock associated with information technology, have created an environment in which firms will have to continue to invest to boost output and stay competitive. The investment tax incentives passed earlier this year as part of the stimulus legislation also will encourage business equipment investment.

- *Continued high rates of productivity growth.* Recent growth in GDP and aggregate incomes despite the sluggish labor markets reflects the ongoing high rate of productivity growth in the U.S. economy. Debate continues about the extent to which productivity gains of the late 1990s will persist, but most analysts expect elevated rates of productivity growth to continue.

Short-term negative factors exist, however, including the following:

- *Consumption patterns and consumer sentiment.* Consumer confidence and sentiment are at 9-year lows, despite a recent uptick. Personal consumption spending has been somewhat volatile recently – although a significant part of that is related to the effects of temporary sales incentives such as zero-interest financing for auto sales.

- *Short-term business investment spending.* Businesses face a very uncertain environment and that has had particularly adverse effects on construction projects. By the third quarter of this year, real business structural investment was down 22 percent from the levels that occurred at the end of 2000 – and has been falling at double-digit annual rates in each of the past four quarters. Some of this decline has resulted from the higher costs of insurance – or the inability to get it at all for high profile construction projects – in the wake of September 11.

- *Soft labor markets.* Although a high rate of productivity growth bodes well for future real growth and higher standards of living in the long run, in the short run it can hamper the rebound in employment as firms work to maintain or boost output while controlling costs.

- *A manufacturing pause.* Data on the Institute of Supply Management's purchasing managers index [PMI] and industrial production show that the manufacturing sector is flat – or even contracting slightly – in recent months.

- *Heightened uncertainty and risk.* Perhaps the biggest remaining problem, however, is the ongoing uncertainty and risk associated with the "new environment" of the economy – following the bursting of the stock market bubble and the attacks of September 11, as well as reflecting the uncertain outlook for conflict with Iraq.

It remains to be seen how the U.S. economy, with its inherent flexibility and resilience, works through the current situation in the face of higher uncertainty and related risks.